Central Banks

Yellen’s Testimony Highlights Growing Concerns

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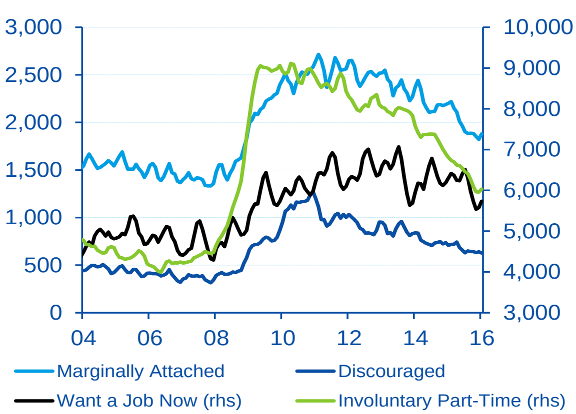
- **Testimony reiterated FOMC views on strong labor market, moderate economic growth, and eventual increase in inflation once temporary factors fade**
- **Focus on global and financial market uncertainty highlights underlying concerns that are weighing on the current economic outlook**
- **Yellen and her colleagues likely more worried than they are willing to admit, and therefore we do not expect them to stick to projections for another rate increase in March**

Chair Yellen’s semi-annual monetary policy report to Congress did not clarify FOMC plans for the March meeting but instead built on recent Fedspeak minimizing concerns on the latest happenings in the global economy. The testimony itself was par for the course. Yellen reiterated views on recent economic developments, highlighting ongoing improvements in the labor market as well as “continued moderate expansion in economic activity”. She acknowledged her usual labor market indicators that still require “further sustainable improvement” such as the marginally attached and involuntary part-time employed individuals. Despite her tendency to brush off overly negative comments on the economy, there was not much to suggest a bright side to the outlook, except for the “possibility that low oil prices will boost U.S. economic growth more than we expect.”

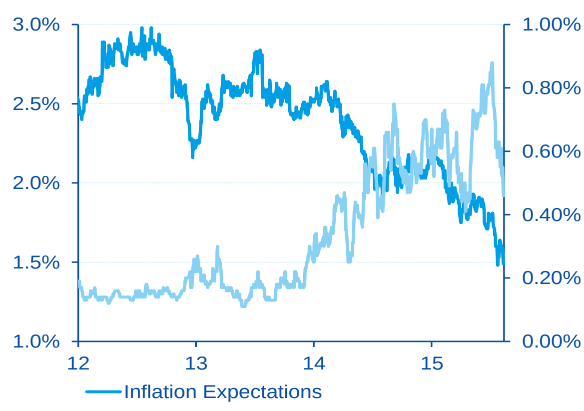
Comments on inflation were no different than what has been said throughout the past few months. Yellen and her colleagues are still adamant that downward pressures on inflation will soon fade once oil prices start to rise again. The problem is that signs are not pointing to a rise in prices anytime soon, so it will be interesting to see how long the FOMC hangs onto this sentiment before admitting to more serious concerns on low inflation. Yellen did at least acknowledge the historically low levels of market-based measures of inflation compensation, but still argued that long-term inflation expectations “have been reasonably stable.”

Chart 1
Yellen’s Labor Market Indicators (NSA, Thousands)



Source: Bureau of Labor Statistics & BBVA Research

Chart 2
12-Month Implied Federal Funds Rate and Inflation Expectations (%)



Source: FRB & BBVA Research

There was a particular focus on global and financial market uncertainty, emphasizing the importance of such factors on the Fed's future plans. Yellen suggested that "these developments, if they prove persistent, could weigh on the outlook for economic activity and the labor market," though it is likely that current conditions are already having a negative impact on their views, even if she won't directly admit it. The specific mention of China brings back memories of late summer 2015 and the Fed's decision to delay the first rate hike at the September meeting. This is setting the stage for a similar situation to unfold in March, with the FOMC likely to hold back another rate increase despite the fact that December's projections implied a move in 1Q16. In this regard, "monetary policy is by no means on a preset course," leaving the door open for the Fed to react to changing economic and financial conditions on a whim if necessary.

The Q&A was a bit more exciting, but again did not give away any additional details about whether or not the FOMC is planning to stick to their current projected policy path. Given the recent transition to negative rates in Japan, there has been increased focus about what could happen if the Fed had to make a similar move. The Fed is still far from cutting rates, let alone going negative, at least in Yellen's mind. However, a large part of Yellen's job is to control market reactions with her commentary, so the fact that she is strongly against the need to cut rates could merely be a tactic to limit any unnecessary public overreaction at this time.

In regards to negative rates, there was a question whether the Fed actually has legal authority to make such a drastic decision. Yellen noted that this still requires some investigation, even though she argues that negative rates are certainly not necessary at this time. This is an interesting question and could bring up some conflict with Congress if the economy deteriorates and conditions warrant more dramatic monetary policy action.

Overall, Yellen seems to be taking the road more often traveled by the Fed – cautious, yet hopeful that economic conditions will evolve in line with their relatively optimistic outlook. Although she is clearly aware of the recent bout of negative economic activity, she remains "careful not to jump to a premature conclusion about what is in store for the U.S. economy." With this in mind, current conditions suggest that it may be premature for the FOMC to raise rates again in March. Therefore, we also expect to see a downward revision to their policy path projections at the upcoming meeting.